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SUBJECT: TURKEY: LIRA DEPRECIATES SHARPLY

REF: A. ANKARA 1855
¶B. ANKARA 1820
¶C. ANKARA 1763
¶D. ANKARA 1744

¶1. Sensitive but unclassified. Not for internet distribution.

¶2. (SBU) Summary: The Turkish lira has taken a pounding, falling 37% against the dollar this month and 14.5% from October 20 to 24. The lira's sharp fall is mainly the result of foreign investors selling Turkish assets (USD $14 billion capital outflow since October 1) and of Turkish companies and banks buying foreign exchange to make foreign currency debt payments. Thus far, the depreciation has been orderly and banks are not reporting a movement by Turks out of the lira and into foreign currency. The GOT continues to publicly say that the crisis will not directly affect Turkey or Turkish banks, while at the same time proposing various measures in response, the most substantive being incentives for Turks to repatriate offshore funds. Meanwhile, the Central Bank (CBRT) has quietly instituted several measures aimed at heading off a FX liquidity shortage. On October 9, it assumed counterparty risk in the interbank FX market (reftel C). On October 24, it doubled the amount of FX that local banks could borrow from the Central Bank on a short-term basis and reinstituted daily FX auctions. The CBRT's focus is on maintaining FX liquidity, not supporting the exchange rate. The Bank's Monetary Policy Committee (MPC) declined to support the lira with an interest rate increase on October
¶22. The MPC statement indicated that the Bank recognizes the inflationary impact of the lira's depreciation, but felt it would be largely offset by falling energy and food prices. End summary.

¶3. (SBU) The Turkish lira has depreciated sharply as foreign investors, banks and local companies adjust their expectations in response to the global financial crisis. The lira fell 14.5% against the dollar in the first four days of this week, October 20 through 24. Through October 24, the lira has lost 37% this month. The depreciation was driven by investors selling off Turkish assets, particularly hedge funds that had taken large lira positions as part of carry trades (the Central Bank's Markets Department estimates the capital outflow from Turkey at USD $14 billion since October 1), and by Turkish banks and companies buying FX in anticipation of large FX-denominated debt payments coming due in the next two months.

¶4. (SBU) The GOT continues to take the public position that Turkey does not need to take any extraordinary measures in response to the crisis, while at the same time proposing various measures to respond to the effects of the crisis (see reftels B, C and D), the most substantive of which is a proposed new law giving incentives for Turks to repatriate funds held offshore. On October 24, Treasury Minister Simsek rejected business sector calls for the GOT to negotiate a new IMF Standby Agreement, saying the GOT "does not currently

feel the need for a new accord that would involve the use of new funds from the IMF," but left open the possibility of negotiating a Precautionary Standby (Reftel A).

¶5. (SBU) Without much public fanfare, the CBRT has moved aggressively to head off a FX liquidity shortage. On October 9, the CBRT announced it would enter the interbank FX Depot Market as a broker (reftel C), effectively taking on all counterparty risk and keeping the interbank FX market liquid and functioning. On October 24, the CBRT announced it would double the amount of FX that banks could borrow directly from the CBRT on a short term (up to two week) basis to USD $10.8 billion, and that it would resume daily FX auction sales. Comment: The CBRT not only deserves credit for moving aggressively to maintain FX liquidity, but also doing it in an intelligent manner. It has priced its FX loans above market rates, thereby supporting the interbank market and acting only as a lender of last resort. The doubling of direct FX lending limits responds to fears of an FX shortage in the next few months when approximately USD $10 billion in FX loans come due. The CBRT move assures the market that banks will be able to meet their FX obligations even if they have problems rolling over their offshore FX loans. The move also may give Turkish banks the security they need to roll over the FX-denominated credit lines they have extended to Turkish companies. This is an important source of FX funds for Turkish companies. According to Barclays Capital, Turkish banks have USD $24 billion in FX-denominated credits outstanding to Turkish companies, 70% of which are short-term. End comment.

¶6. (SBU) The CBRT is focusing its efforts on maintaining FX liquidity, not on protecting the exchange rate. The CBRT's Monetary Policy Committee (MPC) decided October 22 not to raise the CBRT's policy rate (16.75%) in response to the lira's depreciation, and lowered its lending rate by 50 basis points (to 19.75%). The MPC statement recognized that the lira's depreciation will cause an uptick in inflation, but felt that the inflationary pressures would be largely offset by the expected fall in energy and food prices. (Note: most Turkish production contains imported inputs, and any lira depreciation results in "imported" inflation. Economists estimate the inflation pass through from lira depreciation is .20-25% over the following 12 months, with about 60% of that impact in the first four months. Thus the 37% lira depreciation so far in October will translate into between 4.4% and 5.6% of additional inflation from November to February. End note.)

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